10 Tips for Preparing Your 2024 "Pay Versus Performance" Disclosure

With the 2024 proxy season just around the corner, it's time to begin preparing the executive compensation information that will need to be included in the proxy statement for your 2024 annual meeting of shareholders, including the second round of "pay-versus-performance" disclosure. As we learned in 2023, the "pay-versus-performance" disclosure required by the SEC's executive compensation disclosure rules can be both challenging and, at times, tedious; with the disclosures of many technology and life sciences companies averaging four pages of often highly-detailed information. The good news is that for purposes of this next disclosure cycle, most companies will be able to leverage the knowledge gained from their initial filings in drafting their disclosure. In addition, we also have the benefit of the comments issued by the SEC Staff from their review of the initial batch of "pay-versus-performance" disclosures, as well as the Staff's interpretive guidance (comprising 30+ Compliance and Disclosure Interpretations) at our disposal.

To assist you with this year's disclosure, we highlight several items that we have learned over the past several months that should help make your 2024 compliance efforts go more smoothly. If this is your first time complying with the "pay-versus-performance" disclosure rule, or if you would like to refamiliarize yourself with the rule's requirements, please see our Thoughtful Pay Alert, SEC Adopts New Rules for "Pay Versus Performance" Disclosure Requirement (Sept. 9, 2022), as well as our Thoughtful Disclosure Alert, "Pay Versus Performance" Disclosures in the Technology and Life Sciences Sectors (Oct. 24, 2023).

10 Tips for Preparing Your 2024 "Pay-Versus-Performance" Disclosure

- Companies May Limit Reconciliation Tables to the Most Recently Completed Fiscal Year for "Pay-Versus-Performance" Tables Following Their Initial Table
- Companies May Omit Confidential Information When Disclosing Material Changes in Assumptions in Calculating "Compensation Actually Paid"
- Use of Custom Peer Group in Subsequent "Pay-Versus-Performance" Tables Requires Calculating Peer Group TSR for all Fiscal Years Presented Using the Most Recent Fiscal Year Peer Group
- Date When Performance-Based Vesting Condition is Considered Satisfied Depends on Specific Facts and Circumstances
- Absent Limited Exceptions, Changing the Composition of Custom Peer Group in Subsequent "Pay-Versus-Performance" Table Requires Comparison of Company TSR to Both New and Former Peer Groups
- Companies May Specifically Designate Only One Financial Performance Measure as the "Company-Selected Measure"
- Disclosure of Named Executive Officers Must Include All Individuals Who Were Named Executive Officers at Any Time During Covered Fiscal Year
- Broad Equity Market Index May Not be Used to Calculate Peer Group Cumulative TSR
- Smaller Reporting Companies That Lost This Status as of January 1, 2024 May Continue to Use Scaled Disclosure in 2024 Proxy Statements if Filed Within 120 Days of 2023 Fiscal Year End
- Emerging Growth Companies That Lost Status as of January 1, 2024 Should Probably Use Published Industry or Line-of-Business Index to Report Peer Group Cumulative TSR

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10 Tips for Preparing Your 2024 "Pay Versus Performance" Disclosure (Continued)

1. Companies May Limit Reconciliation Tables to the Most Recently Completed Fiscal Year for "Pay-Versus-Performance" Tables Following Their Initial Table

When calculating "compensation actually paid" ("CAP") for your principal executive officer and, on average, for your other named executive officers ("NEOs"), SEC rules require companies to disclose in footnotes to the "Pay-Versus-Performance" Table each of the amounts deducted and added pursuant to the rules to arrive at the appropriate CAP amounts for each covered fiscal year. Since these footnotes may be quite voluminous where a company is providing CAP amounts following its initial "Pay-Versus-Performance" Table, the SEC Staff has indicated that it is permissible to limit such information to the most recent fiscal year unless the information for prior fiscal years is material to an investor's understanding of the information reported for the most recent fiscal year or the required relationship disclosure comparing CAP and the various financial performance measures included in the table *(see Compliance and Disclosure Interpretation Question 128D.03)*. However, in its initial "Pay-Versus-Performance" Table, a company must provide footnote disclosure for each of the periods presented in the table.

2. Companies May Omit Confidential Information When Disclosing Material Changes in Assumptions in Calculating "Compensation Actually Paid"

SEC rules provide that, for purposes of calculating CAP, if in determining an equity award's "fair value" any assumption made in the valuation differs materially from that disclosed as of the grant date of such equity award, a company must disclose the assumption in a footnote to the "Pay-Versus-Performance" Table. While this requirement is likely to arise most often when recalculating the "fair value" of stock options (or performance share awards containing a market condition), it may also come up in the context of performance share awards containing a performance condition. In fact, the SEC rules specifically provide that "for any awards that are subject to performance conditions, calculate the change in fair value as of the end of the covered fiscal year based upon the probable outcome of such conditions as of the last day of the fiscal year."

If satisfying this disclosure would involve confidential information (as may be the case where the probable outcome has changed from one fiscal year to the next), the disclosure of which would result in competitive harm to the company, it may omit the information if it would be eligible for this confidentiality protection. Where this situation arises, however, the company must be as transparent as possible without disclosing the confidential information, such as giving a range of outcomes or discussing how the performance condition impacted the "fair value" determination. In addition, the company should discuss how the undisclosed change in the probable outcome assumption affects how difficult it will be for its executives to earn the underlying award or how likely it will be for the company to attain the performance condition *(see Compliance and Disclosure Interpretation Question 128D.22)*.

3. Use of Custom Peer Group in Subsequent "Pay-Versus-Performance" Tables Requires Calculating Peer Group TSR for All Fiscal Years Presented Using the Most Recent Fiscal Year Peer Group

SEC rules require companies (other than smaller reporting companies ("SRCs")) to disclose their peer group cumulative TSR, with the "peer group" being either the published industry or line-of-business index used for purposes of the stock performance graph included in either its "glossy" annual report or its annual report on Form 10-K or, if applicable, the companies it uses as a peer group for purposes of its Compensation Discussion and Analysis ("CD&A"). Where a company is using the CD&A peer group (rather than the performance graph peer group) to report peer group cumulative TSR, it must use the peer group that it is disclosing in its current proxy statement as the peer group for each of the fiscal years covered in the "Pay-Versus-Performance" Table. In other words, in the case of a company with a calendar fiscal year-end, the cumulative peer group TSR disclosed in the table for fiscal 2020, 2021, 2022, and 2023 is to be calculated based on the company's 2023 peer group *(see Compliance and Disclosure Interpretation Question 128D.07)*.

4. Date When Performance-Based Vesting Condition is Considered Satisfied Depends on Specific Facts and Circumstances

If an equity award containing a performance condition requires certification by the board of directors or the compensation committee that the target level of performance was attained, the provision should be analyzed to determine whether the award should be considered vested as of fiscal year-end or if the certification requirement creates an additional substantive vesting condition, such that an executive does not vest in the award unless and until the performance result has been certified (including awards that require the executive to remain employed through the date such certification occurs) *(see Compliance and Disclosure Interpretation Question 128D.19)*. The answer to this question will determine when the award's final "fair value" should be determined to calculate the CAP attributable to the award.

5. Absent Limited Exceptions, Changing the Composition of Custom Peer Group in Subsequent "Pay-Versus-Performance" Tables Requires Comparison of Company TSR to Both the New and Former Peer Groups

SEC rules require companies (again, other than SRCs) that select or otherwise use a different peer group from the peer group used in the prior fiscal year – that is, that add and/or remove a peer company – to explain, via footnote, the reason or reasons for the change and compare the company's cumulative TSR with the cumulative TSR of both the new peer group and the former peer group. The SEC Staff has indicated that there are two situations where a comparison between the new and former peer group is not required: (i) a company is omitted from the peer group solely because it is no longer in the industry or line-of-business or (ii) the changes in peer group composition are the result of the application of

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pre-established objective criteria (such as where the company has consummated a merger or other acquisition) *(see Compliance and Disclosure Interpretation Question 128D.27).* In these two cases, the company must disclose the specific description of, and the bases for, the change, as well as the identities of the companies removed from the peer group.

6. Companies May Specifically Designate Only One Financial Performance Measure as the "Company-Selected Measure"

Companies may provide additional financial performance measures in the "Pay-Versus-Performance" Table beyond what is required, but such additional measures need to be designated as "supplemental." The SEC rules provide that, in addition to providing a company's TSR and net income in the "Pay-Versus-Performance" Table for each covered fiscal year, the company is also required to disclose an amount for each covered fiscal year attributable to an additional financial performance measure which in the company's assessment represents its most important financial performance measure used to link compensation actually paid to its NEOs to company performance (the "Company-Selected Measure," or "CSM"). While SEC rules contemplate that a company designate a single measure as its "CSM," it is not precluded from disclosing a second (or third) important financial measure in the "Pay-Versus-Performance" Table as long as the information is not misleading and does not obscure the required information. In the case of adding another such financial performance measure, this means labeling the measure as "supplemental," either in the table itself or in a footnote to the additional column.

7. Disclosure of Named Executive Officers Must Include All Individuals Who Were Named Executive Officers at Any Time During Covered Fiscal Year

In addition to disclosing the total compensation reported in the Summary Compensation Table ("SCT") and CAP for its principal executive officer(s) in the "Pay-Versus-Performance" Table, a company must also disclose the average SCT total compensation and CAP for its other NEOs. This group includes all individuals who were NEOs at any time during a covered fiscal year, not just the NEOs who were serving as such at the end of the last completed fiscal year. *Compliance and Disclosure Interpretation Question 128D.30* provides that where a company has multiple principal financial officers during a single covered fiscal year, each NEO must be included individually in the calculation of average compensation amounts. In addition, any individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer of the company at the end of the last completed fiscal year (that is, a former NEO) should also be included in the calculation.

8. Broad Equity Market Index May Not be Used to Calculate Peer Group Cumulative TSR

Although *Compliance and Disclosure Interpretation Question 128D.05* indicates that, for purposes of calculating cumulative TSR of its peer group, a company may use a peer group that is disclosed in its CD&A as used to help determine executive pay, even if such peer group is not used for "benchmarking" purposes, this guidance should not be read too broadly. The SEC Staff has indicated that this guidance does not permit a company to use a broad-based equity market index that it uses to determine the vesting of performance-based equity awards based on relative TSR *(see Compliance and Disclosure Interpretation Question 128D.25).*

9. Smaller Reporting Companies That Lost This Status as of January 1, 2024 May Continue to Include Scaled Disclosure in 2024 Proxy Statements if Filed Within 120 Days of 2023 Fiscal Year-End

SRCs that lose their status as of January 1, 2024 would appear to no longer be eligible to use the "scaled disclosure" system provided in the SEC rules. However, the SEC Staff has indicated that in this initial year as an accelerated filer such a company may continue to include scaled disclosure in its proxy statement as long as it is filed not later than 120 days after its 2023 fiscal year end *(see Compliance and Disclosure Interpretation Question 128D.28).* The "Pay-Versus-Performance" disclosure in this filing must cover fiscal years 2021, 2022, and 2023.

In addition, in subsequent "Pay-Versus-Performance" Tables (that is, in its proxy statement filed in 2025) where the company continues to not be a SRC, it must provide the full disclosure in its "Pay-Versus-Performance" Table for fiscal 2024 and may continue to provide the "scaled" disclosure for fiscal 2021, 2022, and 2023 (in other words, the company is not required to revise its disclosure for prior fiscal years to conform to non-SRC status in such filings). However, because peer group cumulative TSR is calculated on a cumulative basis, the company should include (a) peer group TSR for each fiscal year included in the "Pay-Versus-Performance" Table and (b) its quantifiable performance under its Company-Selected Measure for each fiscal year included in the table.

10. Emerging Growth Companies that Lost Status as of January 1, 2024 Should Probably Use Published Industry or Line-of-Business Index to Report Peer Group Cumulative TSR

Emerging growth companies ("EGCs") that lose their status as of January 1, 2024 (and which do not qualify as SRCs) must comply with the full "Pay-Versus-Performance" disclosure requirements. This means that their disclosure must include in the "Pay-Versus-Performance" Table (i) three years of information, (ii) their cumulative TSR and the cumulative TSR of their peer group, (iii) a Company-Selected Measure, and (iv) a Tabular List. For purposes of reporting the cumulative TSR of their peer group, the company is required to use as its peer group either the published industry or line-of-business index used for purposes of its stock performance graph or, if applicable, the companies it uses as a peer group for purposes of its CD&A. It appears that, in this situation, it may be simpler for the company to use the published industry or line-of-business index used in its stock performance graph (which disclosure is required of EGCs). The use of a compensation peer group is more problematic since, as an EGC, the company will not have included a CD&A in its previous proxy statements. However, it appears that it may

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be permissible for the company to use the compensation peer group that will be disclosed in its initial proxy statement as an accelerated filer.

Observations

While compliance with the "Pay-Versus-Performance" disclosure requirements should be easier than in 2023, there will still likely be challenges that companies have to address in preparing their "Pay-Versus-Performance" Table and related discussions of the relationship between the CAP to their NEOs and company performance. We expect that various stakeholders, who were relatively quiet in their reactions to the initial round of disclosure, may have more to say about the correlation between pay and performance with the benefit of an additional year of disclosure. We also expect now that companies have had an opportunity to view the disclosures of their peers and the broader market, there may be a movement towards greater harmonization of the disclosure among companies – at least in terms of formatting and presentation. Finally, since companies were largely left to their own devices in deciding what constituted "good faith" compliance in 2023, now that we are more familiar with the mechanics of compliance and have nearly three dozen interpretive responses from the SEC Staff on how the "pay-versus-performance" rule should be applied, we may see some companies shift their approach to take advantage of the SEC Staff guidance and to fit within the emerging "best practices" for this disclosure item.

Need Assistance?

Compensia has extensive experience in helping companies analyze the requirements of the SEC's "pay-versus-performance" disclosure rule, as well as drafting the required disclosure. If you would like assistance in preparing your "pay-versus-performance" disclosure, or if you have any questions on the subjects addressed in this Thoughtful Disclosure Alert, please feel free to contact the author of this Alert, Mark A. Borges at 415.462.2995 or mborges@compensia.com.

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